

Written Statement of

Peter Conti-Brown  
Academic Fellow  
Stanford Law School  
Rock Center for Corporate Governance

Before the Senate Committee on Banking, Housing, and Urban Affairs

“Reforming the Federal Reserve System: Structure over Functions”

March 3, 2015  
2:30pm

## **Witness Background Statement**

**Peter Conti-Brown** is a legal scholar and financial historian studying central banking, financial regulation, and public finance. He is a non-resident Academic Fellow at Stanford Law School's Rock Center for Corporate Governance and a PhD student in history at Princeton University where he is the John R. Irwin Fellow in History. As of July 2015, he will be an assistant professor of legal studies and business ethics at the Wharton School of the University of Pennsylvania. His articles have appeared or are forthcoming in the *Yale Journal on Regulation*, and the *Stanford*, *UCLA*, and *Washington University Law Reviews*, among other journals. He is the editor, with David Skeel, of the book *When States Go Broke: Origins, Context, and Solutions for the American States in Fiscal Crisis*, published by Cambridge University Press and editor, with Rosa Lastra, of the *Research Handbook on Central Banking*, forthcoming from Edward Elgar Publishing. His book *The Power and Independence of the Federal Reserve* is forthcoming from Princeton University Press. He has been quoted in print and online articles published by *The Atlantic*, *The Economist*, *The New York Times*, and Reuters, and has appeared on C-SPAN and National Public Radio.

Conti-Brown graduated from Harvard College, magna cum laude and Phi Beta Kappa, and Stanford Law School, and clerked for the Hon. Stephen F. Williams on the United States Court of Appeals for the DC Circuit and the Hon. Gerard E. Lynch on the United States Court of Appeals for the Second Circuit. Since 2013, he has been Of Counsel at the appellate litigation boutique Gupta Beck PLLC.

This testimony is derived in part from a paper Conti-Brown presented at the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution on March 2, 2015. The paper comes in part from the book *The Power and Independence of the Federal Reserve*, forthcoming from Princeton University Press. Conti-Brown does not speak or write on behalf of the Hutchins Center, the Brookings Institution, or any other organization.

Mr. Chairman, Ranking Member Brown, Members of the Committee:

My name is Peter Conti-Brown and I am an Academic Fellow at Stanford Law School's Rock Center for Corporate Governance. In July, 2015, I will be an assistant professor of legal studies and business ethics at the Wharton School of the University of Pennsylvania. I am here today as a legal scholar and a financial historian who studies the institutional evolution of central banking, especially in the United States. Much of what follows comes from a paper I presented on March 2, 2015, at the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution. As noted above, I reiterate that I speak only on my own behalf.<sup>1</sup>

It's been an exhausting 7 years to be a central banker. It began in the summer of 2007 and extended through the shotgun marriage between JPMorgan Chase and Bear Stearns, the concomitant resurrection of unusual lending authority, the ongoing implementation of unconventional monetary policy, and so much else in between. To paraphrase Thomas Paine, these have been the times that try central bankers' souls, that test the resolve of the summer hawk or the sunshine dove.

But these central banking times have been trying not only, perhaps not even especially, for central bankers, but also for the public they serve. This heterogeneous public—including longstanding Fed watchers and those who have only recently realized that the United States has a central bank, those who love the Fed, and those who hate it—has not always, or indeed not even very often, been fully comfortable with these decisions. The emergency lending—the “bailouts,” in the popular if misleading parlance—that began with Bear Stearns and accelerated through the alphabet soup of Fed and Treasury programs gave birth to the populist-libertarian revival of 2010. And the monetary policy response, especially in unconventional monetary policy, has only exacerbated these tensions. The views of once and future presidential hopeful Rick Perry are emblematic of the feelings of many in the American polity: quantitative easing was “printing more money to play politics,” and was, by Perry's lights, “almost treacherous, or treasonous.”<sup>2</sup> In the United States, the Fed and its chair were among the most admired of agencies and officials in government at the time of, for example, Alan Greenspan's retirement in 2006; just a few years later, they were among the lowest (Conti-Brown, 2015b).

As a consequence, there has been no shortage of discussions—during the crisis and unceasingly since—about how to reform the Fed. Most of these discussions, though, have been on reforming the Fed's functions. That is, changing the way it lends money in an emergency, how it determines which financial institutions are systemically important, how it accounts for its spending and decisions, how it determines its models of the economy, and how it makes monetary policy. The answer to the question: “What does the Fed do, and what should it do?” is no doubt essential to our understanding of what lessons for central banking we are to take from the recent crisis.

---

<sup>1</sup> Much of the detail, the citations, and other supporting evidence is contained in that paper: “The Twelve Federal Reserve Banks: Governance and Accountability in the 21<sup>st</sup> Century,” available at [http://www.brookings.edu/~media/Research/Files/Papers/2015/03/02-fed-banks-21st-century/fed\\_banks\\_21st\\_century.pdf?la=en](http://www.brookings.edu/~media/Research/Files/Papers/2015/03/02-fed-banks-21st-century/fed_banks_21st_century.pdf?la=en)

<sup>2</sup> Zeleny, Jeff, and Jackie Calmes, 2011. “Perry Links Federal Reserve Policies and Treason.” The New York Times, U.S. Politics, August 16.

Less discussed, however, is the Fed's structure, raising the question, "Who is the Fed?" Public and scholarly attention on the Fed usually focuses on a monolithic it, or on the personal she or he. In fact, the standard grammatical practice—followed in this paper—is to refer to the Federal Reserve (or just "the Fed") as a proper noun. The Fed raised interest rates; the Fed bailed out AIG; the Fed issued new banking regulations; the Fed fired a bank examiner for challenging Goldman Sachs. But this linguistic practice is an institutional, and even grammatical, error. The term "Federal Reserve" is not a noun, but a compound adjective. There are Federal Reserve Banks, Federal Reserve Notes, a Federal Reserve Board, and, taken together, a Federal Reserve System, all created by the Federal Reserve Act of 1913. But there is no "Federal Reserve" by itself.<sup>3</sup> This vocabulary failure belies a harder problem for thinking about the Federal Reserve System—even though we rarely refer to it as such, to paraphrase Kenneth Shepsle, the Fed is a "they," not an "it."<sup>4</sup>

This is not a pedantic grammatical point. Understanding the Fed's complex ecosystem and the institutional actors within the Federal Reserve System is essential to understanding the space within which the Fed makes policy. It also speaks to the very independence that some distrust and others hold very dear. This complexity also illustrates a problem not just of public understanding—though it is certainly that—but also one of governance. When the public is faced with a monolith, all debates about Fed actions—no matter where they occur within the system, and no matter what those actions may be—easily spiral into debates. Such debates involve the first principles about the gold standard, the Coinage Clause of the U.S. Constitution, and the pure democratic virtues of Thomas Jefferson over the venal tyrannies of Alexander Hamilton.

My book, *The Power and Independence of the Federal Reserve* takes up the largely descriptive task of laying out the governance, independence, and structure of the Federal Reserve System, especially as that structure has evolved over time.<sup>5</sup> It relates it to the conception of central bank independence that grew out of a historical moment in the 1980s and 1990s. But this paper examines one aspect of the largely normative issue of central bank design: not what the Fed is, but what it should be. In particular, this is a question of the federal in the Federal Reserve, looking at the curious decisions of institutional design to place some authority in a government agency in Washington, DC, and other authority dispersed unevenly in mostly private regional Federal Reserve Banks. It is a question of whether or not this failed experiment in quasi-federalism and central banks (and without question, it was a failure) should inform our discussions of structural reform today.

My policy prescriptions vary from those offered by Sen. Paul, who recommends an audit of the Federal Reserve, and different too from the bill pending before the House Financial Services Committee, that would mandate that the Fed follow a monetary policy rule or explain its deviations to congressional hearings and the Government Accountability Office. These bills focus on the *policies* of the Fed. Given the massive uncertainty about the future and the real potential for mischief that subjecting the Federal Reserve to the day-to-day of political pressure could produce, I favor instead focusing on the Fed's governance structure and the proposal that

---

<sup>3</sup> To highlight this point, in the original debates during, and for many years following, the passage of the Federal Reserve Act of 1913, the only word capitalized was frequently "Federal;" it was the "Federal reserve board" and the "Federal reserve banks."

<sup>4</sup> Shepsle (1992).

<sup>5</sup> Conti-Brown (forthcoming, 2015).

we should have more presidential and congressional control at the highest level of policy-making at the Federal Reserve.

### The Reserve Banks

Once we accept that there is a role to play for government in implementing policies that redound to the social good—a sometimes contested proposition, but one that enjoys relatively widespread support—we must answer two additional questions: (1) How will those governmental agents be selected?, and (2) Will their policies reflect that “social good,” or some other set of values?

This is the fundamental question for the Reserve Banks’ continued participation in the formulation of the nation’s banking and monetary policies. As I explain in more detail elsewhere, the Reserve Banks—especially the Federal Reserve Bank of New York—have the potential to make policy and constitutional trouble. Reforming the Reserve Banks by revisiting the question of the appointment of their leaders should be the top priority of any politician who wants the system to conform to constitutional requirements and to allow meaningful democratic accountability.

The problems with the Reserve Banks are in the nature of their appointment and restrictions on their removal. There are three alternatives for resolving this problem: (1) make the U.S. President responsible for appointing the Reserve Bank presidents; (2) make only the president of the Federal Reserve Bank of New York a Presidential appointment, or most convincing, (3) make the Board of Governors responsible for *both* appointing *and* removing the Reserve Bank presidents. I will address each in turn.

The first alternative is the perennial proposal to vest the appointment of the Reserve Bank presidents in the U.S. President, with the Senate confirming those appointments. This would resolve absolutely the constitutional issues of appointment and removal, which I address in more detail elsewhere.<sup>6</sup> And the statute could be clarified to demonstrate a hierarchy in nonmonetary policy, placing the Reserve Banks under the supervision of the board. But this would also allow the Reserve Banks to remain on the FOMC as equals to the governors. Given the diversity of their views, this seems a promising reform.

Of course, the recent trend toward failing to fill the appointments on the Board of Governors may suggest that the fate would be the same for the newly installed Presidential appointments at the Reserve Banks, as discussed above. This possibility also points toward rendering the Reserve Banks fully accountable to the Board of Governors. At the same time, it is not likely that we would see the same vacancy rates at the Reserve Banks as we have at the Board of Governors, for two reasons. First, filibuster reform made it much harder for the

---

<sup>6</sup> See Conti-Brown, “The Institutions of Federal Reserve Independence,” *Yale Journal on Regulation*, forthcoming 2015.

minority party to block presidential nominees. And second, the vastly expanded Senate franchise at the Federal Reserve might make Reserve Bank presidents look more like ambassadors or U.S. attorneys, positions that don't usually attract the same kinds of partisan political attention we associate with Senate gridlock. Even so, this concern is enough to weigh against a policy proposal in favor of rendering the Reserve Banks presidential appointments.

There's another reason why making the heads of the 12 Reserve Bank Presidential appointments seems a misplaced policy. It would almost be sentimental. If all members of the FOMC become Presidential appointments, the value of a 19-person committee must come from something other than the process of their appointment (the strongest justification under the current arrangement). If the problems that inhere to the other proposed alternatives are enough to defeat those proposals—that is, to subject the Reserve Bank presidents to board removal, or board appointment and removal—it may be appropriate to entertain the idea that motivated Marriner Eccles back in 1935: removing the Reserve Banks entirely from the world of making policy. The Reserve Banks could continue to exist as branch offices of the Federal Reserve in the 12 cities where they are located, but they would not participate on the FOMC. And, consistent with Carter Glass's original conception, the Fed could then expand its presence even more evenly to other cities, even removing regional banks from places where they no longer serve a useful purpose. That way, we could revisit some of the decisions about the design of the system that were curious even in 1914 when they were decided: Do we really need two Fed branches in Missouri, and only one west of Dallas?

Third, Senator Jack Reed (D-RI) has proposed making only the president of the Federal Reserve Bank of New York subject to Presidential appointment and Senate confirmation. The Federal Reserve Bank of New York and its president are by far the most important players in the system from both banking and monetary policy perspectives. Giving more presidential and congressional accountability to this key figure in the financial system would go a very long way to ensuring that the public can participate, appropriately, in the governance of its central bank.

I would prefer a third proposal: Vest the appointment and removal of the Reserve Bank presidents in the Board of Governors.<sup>7</sup> There would no longer be multiple layers of removal protection, nor a complicated asymmetry in the appointment and removal dynamic. In that sense, the change would complete the revolution in central banking design that Marriner Eccles began 80 years ago.

This solution does present something of a quandary. If the Board of Governors fully appointed, and could remove at will, the Reserve Bank presidents, what would be the point of the 19-person FOMC at all? Wouldn't this just make the Federal Reserve Bank president a member

---

<sup>7</sup> The Federal Reserve Act does give the Board of Governors approval over the appointment of the Reserve Banks. While there are anecdotal reports about the frequency with which the board exercises this veto, this still needs to be confirmed systematically. "The president shall be the chief executive officer of the bank and shall be appointed by the Class B and Class C directors of the bank, with the approval of the Board of Governors of the Federal Reserve System, for a term of 5 years" (12 U.S.C. § 341).

of the Fed's senior staff? And why give them votes on the nation's monetary policy?

The answer to these questions seems obvious. Making the Reserve Bank presidents fully subject to board appointment and removal would also mean the abolition of the FOMC and the consolidation of all the Fed's legal authority at that board. As mentioned earlier, even for those who favor the mixed committee system as a check on inflation, there are sharper ways to accomplish this task. It's unclear what we gain by having such an unwieldy committee.

One argument in favor of retaining the current committee size is that each Reserve Bank president comes equipped to FOMC meetings, at least in part, with research conducted independent of the board's own staff assessments. But this feature of the Fed's dispersed research function is preservable, if it is indeed desirable. That is, governors can gain better access to staff assessments, rather than consume only the options the chair has shaped with the staff ahead of FOMC meetings. In other words, getting diversity of research views presented at the FOMC is not tied to the existence of a 19-person committee.

### Federal Reserve Staff

There are currently fifteen divisions at the Fed's Board of Governors, each appointed by the Board, none vetted publicly. For some of them, and perhaps just for one of them, I would propose that the Senate consider revising that appointment process.

For example, the Director of International Affairs exercises extraordinary policy authority on behalf of the United States. True, there is much in the position that is very technical. But there is much, too, that is highly diplomatic. If the Director of International Affairs is seen in the latter role—as essentially the Fed's chief diplomat—presidential appointment is very desirable. The Fed's role in the international economy has increased substantially in the last thirty years. The argument for presidential appointment for this key position is very strong.

The strongest argument for presidential appointment among Fed staff is in the position of General Counsel. The Fed's chief lawyer, as discussed in chapter four, exercises extraordinary authority. As this book has argued at great length, the laws of Fed independence and authority are difficult to parse. The idea that the exercise of legal expertise as a purely technocratic function has been dead for eighty years. These positions require value judgments informed by technical expertise. While I don't argue that these functions should be subject to constant debate on the floor of the House, the case for allowing the public to vet the appointment of these lawyers is essentially ironclad.

Two points of comparison are useful here. First, unlike the case with the other “barons” of the Fed staff, the Fed Board is not in a position to exercise significant oversight over the Fed's chief lawyer. As discussed above, the Fed has become increasingly dominated by economists, a transition away from a tradition of bankers and lawyers. There are good reasons for this transition, but one consequence is that the Fed is not in the position to push back against or even, perhaps, understand the issues of value judgments that a lawyer must make when making a recommendation as monumental as what kind of collateral counts when extending emergency loans or whether an enforcement decision matches the degree of noncompliance with which it is



associated. This is not the fault of the Board, but a reflection that theirs is largely a different kind of expertise. As of this writing, there are two lawyers on the Fed's Board, but only one who has spent a significant portion of his career dealing with the legal issues relevant to the Fed's regulatory work.

Second, while other general counsels at administrative agencies are not subject to presidential appointment, the Fed's chief lawyer makes judgments of extraordinary importance that are unlikely to ever be subject to judicial review. Courts have made clear for eighty years that they will not review the Fed's decision about monetary policy, including when those decisions require novel interpretations of law. And in the crisis, emergency decisions were made that have been effectively removed from judicial review, including violations of state corporate law and issues raised by the Constitution. While judicial review still occurs in many of the Fed's regulatory determinations, in places where value judgments are of the most consequence, the Fed's lawyer is the first and last word on what the law allows or forbids. For this reason, the Fed's chief lawyer should be a presidential appointment.

### Other Policy Proposals

There are two proposals for reform that have circulated historically, perennially, and are pending before this Committee or the House Financial Services Committee. The three proposals are (1) to audit the Fed annually through the Government Accountability Office; and (2) to legislate a monetary policy rule and require the Fed to follow it or explain its deviation to congressional committees with, again, support from the GAO.

The first proposal has been around for decades and continues as a perennial favorite for those who seek to understand and reform the Fed. That proposal is to subject the Fed to an annual, transparent audit performed by the Government Accountability Office. Many within the Fed view the "Audit the Fed" bills and their proponents with fear and loathing and equate the practice with an end of Fed independence. I don't share those convictions, at least not completely. That is, the public audit part of the proposal strikes me as a scholar and as a citizen as an essential part of the way we can understand what the Fed, what the Fed does, and who on the outside tries to influence Fed behavior. And, historically, Congress has mandated at least two partial public audits—in 1978 and 2010—that the Fed vociferously opposed. What we learn about Fed practices, especially from its lending behavior during the crisis, is essential to our comprehension of this opaque institution.

What troubles me about the Audit the Fed bills is the regularity of those audits. The potential for one-off audits is a sufficient deterrent for the truly scandalous behavior. As noted, it is frankly astonishing that the Fed, given its robust financial independence, has never had a scandal such as those that have plagued other agencies including, ironically, the GAO itself. The problem with the regularity of the audits is that they will inject politics deep into the everyday operations of the Fed. At present, the Fed and its officials testify regularly before Congress, but more in a question and answer format. These hearings are public and allow for members of both the House and the Senate committees to explore any question of interest. And the committees can summon the Fed at their own prompting.



What an audit would do is force the Fed to structure all of its activities toward that kind of transparency. While not as much of an intrusion as the hostage holding that would occur through the appropriations process, it would significantly decrease the distance between the Congress and the Fed that currently exists. Because of the deterrent benefits of potential audits and the opportunities that members of Congress already have for public accountability through congressional hearings, I see annual audits as part of the same problem.

The second proposal is the newest, although it too has antecedents in history. That proposal would require the Fed to follow a version of the “Taylor Rule,” a model of the monetary policy for the years 1987-1992 written by Stanford economist John B. Taylor in 1992 and causing a large outpouring of research from Taylor and others following in his wake. The rule would require the Fed to conform its monetary policies to a basic formula that relates a number of variables, including the level of current inflation, unemployment, and targets for economic growth and inflation. The Fed would input a standard set of coefficients to its empirical determination of the economic indicators (inflation, unemployment, the output gap, and so forth); the interest rate is the output of the equation. Within 48 hours of each FOMC meeting, the FOMC would submit to the GAO its determination of the Taylor Rule and be audited thereafter by the GAO. If the Fed deviated from the Taylor Rule, it would have to appear before a congressional committee to explain itself.

This is a very controversial bill, I think for good reason. I am not an economist and have no particular insight into whether the Taylor Rule reflects the best version of monetary policy. But economists do not agree either. Some of the concerns are not about the need for Rules—the Fed has been following a modified version of the Taylor Rule for years. It is on the value of those coefficients, and whether the determinations made in the Taylor paper, based on data from 1987-1992 are in fact portable to all times and all places.

While my research tells us little about whether monetary rules are superior, it does tell us something about the nature of law and personnel. Intricate rules like the one proposed in the Taylor Bill are subject to legal entropy. By inserting the GAO into the monetary policy equation, we cannot predict the institutional consequences. It is not far-fetched to predict, depending on the personnel choices made under the Taylor Bill regime, monetary policy drift from the central bank to the GAO. This result isn’t guaranteed by the bill, of course, but the point of this book is to argue that the legal institutions established at one time period cannot be trusted to stay in place. For this reason, the legal modifications proposed here are entirely about public scrutiny of personnel decisions, not policy rules.

To put the point differently, the Taylor Rule may well be exactly the right approach to monetary policy. If that’s the case, we should appoint John Taylor to the Fed, not insert the GAO and congressional committees into the micromanagement of monetary policy.

## Conclusion

The impulse behind Fed reform on the left and the right comes from the recognition that the Fed wields extraordinary authority that the public does not always understand. At the same time, one of the central innovations of institutional design in the 20<sup>th</sup> century was to create central banks that could exist apart from the day-to-day of electoral politics. The task for the

Congress is to continue to maintain that buffer from politics without eliminating the Fed's public accountability. I believe focusing on the Fed's governance as opposed to micromanaging the Fed's policies is the best way to achieve that balance.